



SECURITIES AND FUTURES COMMISSION  
證券及期貨事務監察委員會

**Responses to the issues arising from the hearing  
on 26 March 2010**

**17 May 2010**



4. In connection with paragraph 17 of S57 stating that Lehman Brothers (LB)-related structured financial products were available for sale to retail investors in some overseas jurisdictions, please provide further information, with reference to some major international centres in North America, Europe and Asia as examples, on the following:
- (a) how the sale of structured financial products (such as LB-related products) to retail investors was regulated;
  - (b) the requirements, if any, applicable to the retail investors (e.g. their net worth, etc.) who purchased such products; and
  - (c) the protection accorded to these investors.

*Introduction*

- 4.1 We will answer these questions with reference to (1) the US; (2) the UK; (3) Australia and (4) Singapore. Where structured financial products are structured as securities we believe that the regulatory regimes in these countries operate in a similar manner to Hong Kong - through a series of elements such as disclosure of the features and risks of a product, conduct regulation (in particular the obligation to assess suitability of the product), licensing, intermediary supervision, enforcement and investor education, so as to provide protection to investors. However, some products are structured in other forms and the regulatory regime may differ (see further below)
- 4.2 We do not attempt to make a direct comparison between the different regulatory regimes on structured products disclosure and conduct regulation because each jurisdiction has its own legal system and securities regulation. It may not be helpful and could even be confusing if the readers try to simply compare the advantages and disadvantages of each system without having regard to the entire system in which those regulatory requirements work. For instance, in the US, there is a more litigious culture which is not otherwise observed in other jurisdictions. However, the regulatory regime in the US for banking, insurance and securities is more fragmented. In comparison, in the UK and Singapore there is a single banking, insurance and securities regulator.
- 4.3 We believe the summary of the four regulatory regimes is accurate. However, the description of these regimes was largely based upon papers and articles available on the internet and it has not been vetted for accuracy by persons qualified in those jurisdictions.

*What are structured financial products ?*

- 4.4 The US Financial Industry Regulatory Authority ("FINRA") Notice to Members (NTM) 05-59 contains a description of structured products intended for the US market but which is applicable generally:

"Structured products are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency.<sup>1</sup> As the foregoing definition

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<sup>1</sup> There is no standardized definition of a structured product in the US federal securities laws or in the UK or EU laws.



suggests, there are myriad types of structured products. Some structured products offer full protection of the principal invested, whereas others offer limited or no protection of the principal.

Most structured products pay an interest or coupon rate substantially above the prevailing market rate. Structured products also frequently cap or limit the upside participation in the reference asset, particularly if some principal protection is offered or if the security pays an above-market rate of interest.

Structured products, which are typically issued by investment banks or their affiliates, have a fixed maturity. Some, but not all, structured products may be listed on a national securities exchange. Moreover, even those structured products listed on a national securities exchange may be very thinly traded.

Structured products typically have two components—a note and a derivative (often an option). The note pays interest to the investor at a specified rate and interval. The derivative component establishes the payment at maturity. In some products, the derivative is, in effect, a put option sold by the investor that gives the issuer the right, but not the obligation, to sell the investor the reference security or securities at a predetermined price. In other products, the derivative is, in effect, a call option sold by the investor that gives the issuer the right, but not the obligation, to buy from the investor the reference security or securities at a predetermined price. Despite the derivative component of a structured product, they are often marketed to investors as debt securities.”

#### *Structures*

- 4.5 Products are offered to investors by the insurance, banking and securities sectors using various structures (called “structures”) that include bank deposits, notes, funds and life assurance bonds.
- 4.6 The structure used by any particular provider could be driven partly by the nature of the company itself but also the fiscal and regulatory regime in a given market. Retail banks will tend to favour the deposit structure. A life company will typically use the independent financial adviser (“IFA”) market and investment linked insurance bonds will be the most likely structure used. Or, depending on the structure, it may be more appropriate for investors to be sold a fund or note. Thus products with essentially similar characteristics appear in different countries in differing guises.
- 4.7 The regulatory regime which applies is therefore dependent upon the structure of the product.

#### *Investor protection - Customer Suitability*

- 4.8 In April 2008, the Joint Forum (consisting of Basel Committee on Banking Supervision, International Organisation of Securities Commissions and International Association of Insurance Supervisors) published a report entitled



*Customer Suitability in the Retail Sale of Financial Products and Services*<sup>2</sup>. The Report considers how regulators across banking, securities and insurance sectors deal with the risks posed by mis-selling of financial products, regulatory requirements to ensure adequate disclosure of information to investors, and requirements for firms to ensure that investment products are suitable for retail investors.

4.9 Eleven jurisdictions<sup>3</sup> were surveyed for the Joint Forum Report<sup>4</sup> on how firms meet their obligations to assess suitability of products. The Report was not limited to sales by securities firms but also covered sales by banks and insurers. Their conclusions included the following points –

- (a) The notion of suitability is recognized in regulatory requirements across all sectors (such as insurance, banking and securities), but to a varying extent. There are some differences in its application by sector, and probably greater differences by country. The differences that do exist may stem, in part, from the fact that not all supervisors have consumer protection mandates.
- (b) The vast majority of countries will not allow firms to 'contract out' of suitability obligations. An exception to this may occur where a client is deemed to be of sufficient net worth or sophistication that he/she is no longer regarded as "retail".
- (c) In most countries, liability for mis-selling of products will fall to the sales agent, rather than the creator of the product.
- (d) In most countries, a suitability requirement only arises when a firm makes a recommendation or provides advice to a client to purchase a product.
- (e) A number of regulators expressed concern about a wide range of "financial products" which fall outside their regulatory jurisdiction, but which displayed similar functionality and characteristics to regulated products.

4.10 The Joint Forum Report comments on changing market conditions –

"Relatively low nominal interest rates have been a factor contributing to rising levels of personal debt on one hand and on the other, increasingly complex financial products for savers in search of greater yield. The growing complexity of financial products may make the associated investment risks less apparent to retail investors, particularly investors reaching for higher yield. This heightens the potential for unsuitable transactions. Financial innovation has also broadened the scope of financial products offered by the insurance, banking and securities sectors. Similar products may be sold to the retail public in all three sectors."

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<sup>2</sup> This Report was an exhibit to the SFC's Report to the Financial Secretary of December 2008 and appears on our website at this address –

<http://www.sfc.hk/sfc/doc/EN/general/general/lehman/Review%20Report/Exhibit%202.pdf>

<sup>3</sup> Australia, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Switzerland, UK and USA

<sup>4</sup> The Report on "Customer suitability in the retail sale of financial products and services" dated April 2008 issued by The Joint Forum consisting of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors.



### *Ongoing changes in regulation*

- 4.11 Whilst we have tried to reflect the current regulatory regimes in the countries we have examined, the regulations are constantly evolving and the financial crisis and the collapse of Lehman have also resulted in changing attitudes towards regulation. Where possible we have highlighted some of these changes. In particular, some countries have introduced<sup>5</sup>, or are considering introducing<sup>6</sup>, provisions requiring product providers to be satisfied that a product is fair, or fit for distribution, before making it available to retail investors.

### **US Regulatory regime**

#### *Market size*

- 4.12 The US Structured Products Association estimates the dollar value of investments in structured products rose to US\$70 billion in 2006 and US\$120 billion in 2007, almost half of which was sold to individual investors.
- 4.13 In 2008, Lehman had sold more than USD 900 million worth of retail structured products in the US up to September 2008, ranking in among the top 10 issuers of the products.<sup>7</sup>

#### *Structures*

- 4.14 Structured products are sold to retail investors in the US using various structures, securities, funds and insurance products being the most popular. Structured products also take the form of derivatives such as stock futures and credit default swaps (which are not subject to the prospectus regime described below).
- 4.15 "Structured products originally became popular in Europe and have gained currency in the U.S., where they are frequently offered as SEC-registered products, which means they are accessible to retail investors in the same way that stocks, bonds, exchange-traded funds (ETFs) and mutual funds are. Their ability to offer customized exposure, including to otherwise hard-to-reach asset classes and subclasses, makes structured products useful as a complement to these other traditional components of diversified portfolios".<sup>8</sup>

#### *Regulatory Regime*

- 4.16 The US Securities and Exchange Commission ("SEC") is the primary securities regulator. It is the responsibility of the Commission to -

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<sup>5</sup> The UK

<sup>6</sup> The EU, Australia and Singapore (in various forms).

<sup>7</sup> According to StructuredRetailProducts.com as quoted in *Another 'Safe' Bet Leaves Many Burned*, WSJ 11 Nov 08

<sup>8</sup> [http://www.investopedia.com/articles/optioninvestor/07/structured\\_products.asp](http://www.investopedia.com/articles/optioninvestor/07/structured_products.asp)



- (a) interpret federal securities laws;
- (b) issue new rules and amend existing rules;
- (c) oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies;
- (d) oversee private regulatory organizations in the securities, accounting, and auditing fields; and
- (e) co-ordinate U.S. securities regulation with federal, state, and foreign authorities.

4.17 Products which are "securities" may only be sold by broker-dealers<sup>9</sup> registered with an SRO called the Financial Industry Regulatory Authority ("FINRA"), or another SRO, which regulates the conduct of their business under US securities laws. However, commercial banks have conditional exceptions from oversight under US securities laws to sell securities to investors, in which case they comply with banking regulator guidance regarding the sale of securities. The term "securities" includes structured products sold with related securities, as well as mutual funds but not insurance contracts. Therefore products structured as insurance contracts are not subject to the prospectus regime.

#### *Prospectus Regime*

- 4.18 Offers of structured products may be conducted as public offerings of securities registered under the Securities Act of 1933 with the SEC. In most cases, structured products are offered from a shelf registration.<sup>10</sup>
- 4.19 An investor purchasing a structured product as part of a shelf distribution will, prior to purchase, receive a preliminary prospectus supplement that describes the characteristics and risks of the structured product being offered. To varying degrees, broker-dealers also use supplemental sales materials.<sup>11</sup>
- 4.20 Prospectus disclosure for structured products registered with the SEC for public offering can be very extensive.

#### *US Regulator - FINRA*

4.21 FINRA, was established in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. FINRA is responsible for registering and educating industry participants, examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering a dispute resolution forum for investors and registered firms.

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<sup>9</sup> So named because these firms both trade securities on their own accounts (i.e. they act as "dealers") or on behalf of their customers (i.e. they also act as "brokers").

<sup>10</sup> NASD NTM 05-59 Guidance Concerning the Sale of Structured Products

<sup>11</sup> NASD NTM 05-59 Guidance Concerning the Sale of Structured Products



- 4.22 FINRA is establishing a consolidated FINRA rulebook that will consist solely of FINRA Rules. Until the completion of the rulebook consolidation process, the FINRA rulebook includes a mixture of FINRA rules, NASD Rules and NYSE Rules.
- 4.23 Broker-dealers are subject to conduct of business rules that stem primarily from the Securities Exchange Act of 1934 as well as by FINRA and securities exchange rules. Breaches may lead to criminal, administrative and civil sanctions – including loss of license<sup>12</sup>.
- 4.24 For example, in March 2010 FINRA fined H&R Block Financial Advisors, Inc., \$200,000 for failing to establish adequate supervisory systems and procedures for supervising sales of reverse convertible notes to retail customers. A reverse convertible note is a structured product that typically consists of a high-yield, short-term note of an issuer and effectively a put option that is linked to the performance of an unrelated, or "linked," asset - usually a single common stock, but sometimes a basket of stocks, an index or some other asset<sup>13</sup>. FINRA also fined and suspended H&R Block broker Andrew MacGill for making unsuitable sales of reverse convertible notes to a retired couple. The firm was ordered to pay \$75,000 in restitution to the couple for losses they incurred.<sup>14</sup>
- 4.25 According to FINRA's arbitration statistics, as of June 2009 nearly 400 arbitration claims have been filed with FINRA for investment products categorized as "Derivative Securities" and suitability claims for the first half of 2009 were more than double the number of claims for all of 2006, and misrepresentation claims have more than tripled the number filed in 2006.

*Conduct of business rules*

- 4.26 FINRA members broker-dealers' obligations when selling structured products, include requirements to:
- (a) ensure that all promotional efforts are fair and balanced;
  - (b) ascertain accounts eligible to purchase structured products;
  - (c) deal fairly with customers;
  - (d) perform a reasonable-basis suitability determination;
  - (e) perform a customer- specific suitability determination;
  - (f) supervise and maintain a supervisory control system; and
  - (g) train associated persons.
- 4.27 Given the similar risk profile of many structured products and options, FINRA has advised that broker-dealers also should consider whether purchases of

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<sup>12</sup> Para 6-032 Regulation of International Finance Philip R Wood

<sup>13</sup> Reverse convertible notes are equivalent to ELNs or FLNs.

<sup>14</sup> <http://www.finra.org/Newsroom/NewsReleases/2010/P120914>



some or all structured products should be limited to investors that have accounts that have been approved for options trading.

- 4.28 Similarly, NASD Rule 2630(b)(19)(B) requires that no broker-dealer or person associated with a broker-dealer shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such acknowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

*Products structured as Derivatives*

- 4.29 Structured products which take the form of derivatives such as swaps, futures, options (including single stock futures and credit default swaps) are generally unregulated.
- 4.30 The Commodity Exchange Act ("CEA") amendments in 1974 gave the Commodity Futures Trading Commission ("CFTC") exclusive jurisdiction (with some exceptions) over commodity futures and options markets regardless of the nature of the underlying commodity or interest. By 1999 the CEA was viewed as an impediment to innovation and the Commodity Futures Modernization Act of 2000 ("CFMA") –
- (a) excluded from the CEA certain OTC derivatives; and
  - (b) deregulated financial futures,

except where they are marketed to small investors. The restrictions on sales to small investors were removed in August 2003.<sup>15</sup> The CFMA also excluded certain swaps from being considered a security under the Securities Act of 1933 and the Securities Exchange Act of 1934, but preserved the SEC's antifraud authority and certain other authority over these swaps.

*Products issued or guaranteed by banks*

- 4.31 Under the terms of Section 3(a)(2) of the 1933 Securities Act, securities issued or guaranteed by a bank organized under federal or state law and regulated by a federal statute banking authority (commercial banks) are exempt from registration under the Securities Act because such issuers are regulated by other applicable federal law.

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<sup>15</sup> Congressional Research Service Report RL30434;





## UK Regulatory regime

### *Market size*

- 4.32 In a speech given by Mr. Dan Waters, the UK Financial Services Authority ("FSA") Director of Retail Policy on 12 February 2009, Mr. Waters said

"At the end of September of last year, there was in the region of £34bn of outstanding value in structured products in issue to the UK retail market."

He continued –

"2007 saw a significant pick-up in the sales of structured products in the UK, making the UK the eighth largest market in terms of annual sales in Europe."

### *Regulatory Regime*

- 4.33 The FSA regulates the entire financial services industry (including banking, insurance and securities) and has four objectives under the Financial Services and Markets Act 2000 (FSMA 2000):

- (a) maintaining market confidence;
- (b) promoting public understanding of the financial system;
- (c) securing the appropriate degree of protection of consumers; and
- (d) reducing financial crime.

The FSA aims to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal.

- 4.34 The FSA Chairman has commented on the regulatory philosophy in relation to product regulation, in The Turner Review (March 2009) at page 106 –

"The FSA has in the past been reluctant to accept the idea that it should regulate products in either retail or wholesale markets. Its regulatory philosophy has been based on the assumptions that: (i) firms must be subject to prudential regulation to ensure financial soundness; (ii) they must be subject to conduct of business regulation, including the regulation of selling approaches, to ensure that customers are treated fairly and are well informed; but (iii) that product regulation is not required because well managed firms will not develop products which are excessively risky, and because well informed customers will only choose products which serve their needs. The regulation of selling approaches has included the requirement that products sold should be "suitable" to the individual customer's requirements, but the FSA has not considered it within its remit to prohibit specific products or product design features." [Emphasis added]



### *Prospectus regime*

- 4.35 In the UK, unlisted retail structured products (products that are not securities admitted for trading on a recognised investment exchange market for listed securities) can take the form of many different product types. Depending on the product type, different (sometimes complex) rules apply to the issuer.
- 4.36 The approach is one of 'disclosure regulation' rather than 'product regulation' as there is no straightforward 'approval or eligibility' concept applied.
- 4.37 However, in FSA's view, there are limits to product disclosures as a tool of investor protection, since many consumers do not feel capable of fully understanding the documents and do not typically display the capability to discern which investments constitute value for money. Suitability testing and conflict management rules are thus an essential complement to product disclosures.<sup>16</sup>
- 4.38 It was also thought that product regulation (i.e. approval of the product itself based upon commercial and risk factors rather than approval of documents) was not required because well managed firms were expected not to develop [retail] products which are excessively risky. Instead the FSA relied upon sufficient disclosure of features and risks (including in the prospectus for the product) and its "treating customers fairly" initiatives.
- 4.39 The primary responsibilities of the product provider are to ensure that products are soundly designed for the target market, are sold with clear, understandable information (for distributors and where relevant, customers) through appropriate distribution channels and perform as the provider promised. Providers' responsibilities include:
- (a) the design and testing of products and an assessment in broad terms of their suitability for different types of customer;
  - (b) selection of appropriate distribution channels;
  - (c) provision of appropriate information to distributors and, where relevant, customers;
  - (d) monitoring of the end result i.e. in broad terms, to monitor whether there is any indication that products are ending up with the right type of customer, whether the products continue to deliver what the provider promised, and acting when they do not; and
  - (e) delivering prompt post-sale service e.g. claims handling.<sup>17</sup>
- 4.40 Although it remains the duty of distributors to ensure the suitability of products sold to individual investors, all product providers engaged in the design and manufacture of products are responsible for taking account of treating customers fairly (Regulatory Guide Jul 2007). However, as has been

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<sup>16</sup> Remarks by Dan Waters, FSA, in Record of the European Commission's open hearing on Retail Investment Products, Jul 08

<sup>17</sup> FSA - The responsibilities of providers and distributors for the fair treatment of customers Sept 2006 (Annex 1 p.3)



indicated above, the effectiveness of relying on product providers has now been questioned.

*Common structures and regulatory approach<sup>18</sup>*

- 4.41 Unlisted retail structured products can take the form of many different product types and the form of regulation will vary accordingly.
- 4.42 If the product can be considered a deposit, relatively few requirements currently apply - the main requirements are for firms to ensure that marketing is fair, clear and not misleading and that past performance is properly presented.
- 4.43 If the product can be considered a 'packaged product' then particular regulatory requirements apply to the issuer, for example specific disclosure documents (key features documents or simplified prospectuses) must be produced.
- 4.44 If the product is not a deposit or a packaged product, but falls within the definition of a collective investment scheme ("CIS"), then it will be an 'unregulated collective investment scheme' and can only be promoted to particular categories of retail client - with appropriate product disclosure documentation.
- 4.45 If the product is neither a deposit, packaged product nor a CIS, then it might be an 'unlisted security' that has been admitted to trading on a regulated market. In that case, rules relevant to trading on that market will apply, such as those derived from the EU Markets in Financial Instruments Directive ("MiFID"), in addition to the relevant prospectus and disclosure rules in the FSA's Prospectus Rules and Disclosure Rules sourcebooks (these sourcebooks contain rules which have been made pursuant to the EU Prospectus and Transparency Directives respectively).
- 4.46 Finally, if the security is a warrant or a derivative (or some other type of 'complex' financial instrument under MiFID) then the FSA also impose requirements on the direct offer, promotion and sale of these products to retail clients - including specific requirements derived from MiFID applying to non-advised transactions (the so-called 'appropriateness test'), which require the firm to establish the client's knowledge and experience to understand the risks involved.

*Products structured as bank deposits*

- 4.47 In the UK many structured products are structured so as to be, technically, bank deposits. The FSA took over regulation of some activities of banks in 2001 under the new tripartite system, which includes the Treasury and the Bank of England. Banks had been subject to a voluntary code, in relation to deposit taking conduct of business. However, this changed on 1 November 2009 when BCOBS (Banking Conduct of Business rules) came into force
- 4.48 In a consultation paper published in November 2008 the FSA has said that it needed to introduce new regulations mainly because -

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<sup>18</sup> This section of this paper was provided by the FSA



"It is increasingly anomalous that the FSA does not regulate retail consumers' core financial services relationship especially now that we are to regulate payment services; and this anomaly potentially restricts our regulatory effectiveness because we are unable to look comprehensively across all risks affecting firms' retail market activities within our scope."<sup>19</sup>

- 4.49 The Paper proposed that a new framework, which would include new banking conduct of business rules and the FSA's Principles for Businesses, should also apply to structured deposits –

"Structured deposits are technically covered by the banking codes at present. However, it is not evident that this is always recognised on a day-to-day, practical basis. The proposed new framework would unambiguously cover these as deposit products (as is the case already under the FSA's financial promotions rules)."<sup>20</sup>

#### *Licensing regime*

- 4.50 Brokers and financial advisers (referred to as "authorised firms") are required to be authorized by the FSA to conduct regulated activities.
- 4.55 It is a criminal offence to communicate an offer to buy or sell financial products ("issue a financial promotion") in the United Kingdom unless (1) it is issued or approved by an authorised firm; or (2) it is exempt via the Financial Promotions Order.
- 4.56 There are a number of exemptions from the financial promotion regime under the Financial Promotions Order. These exemptions include offers to high net worth individuals and sophisticated investors. High net worth individuals are individuals who certify that they -
- (a) had an annual income to the value of £100,000 or more; or
  - (b) held net assets to the value of £250,000 or more.<sup>21</sup>

#### *Conduct of business rules*

- 4.57 The FSA has set out requirements, similar to the SFC's Code of Conduct, for authorised firms in its Conduct of Business Sourcebook ("COBS") and these have been updated to implement the provisions of the EU Markets in Financial Instruments Directive ("MiFID"). In addition, the FSA's Principles for Businesses are a general statement of the fundamental obligations of authorised firms under the regulatory system. They derive their authority from

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<sup>19</sup> FSA consultation paper 08/19, *Regulating Retail Banking Conduct of Business para 1.8 (November 2008)*

<sup>20</sup> FSA consultation paper 08/19, *Regulating Retail Banking Conduct of Business para 4.13Footnote 22 (November 2008)*

<sup>21</sup> See Section 1 Schedule 5 to the Financial Promotions Order. The term "sophisticated investors" is defined in section 2 of Schedule 5.



the FSA's powers as set out in FSMA 2000 and reflect the FSA's regulatory objectives.

- 4.58 For example, FSA Principle 7 provides that a firm must pay due regard to the information needs of its clients and communicate information to them in a way that is clear, fair and not misleading.

*Suitability determination*

- 4.59 FSA Principle 9 provides that a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment. This is amplified in the FSA's COBS rules for investment business. To this end, the firm must obtain sufficient information to ensure that the recommendation or decision meets the client's objectives, will not result in the client being unable to bear the financial risks and that the client has the knowledge/experience in order to understand the risks.

- 4.60 The suitability rules have been extended to apply to all customers, meaning professional clients as well as retail clients, in relation to firms' MiFID business<sup>22</sup>. Non - MiFID firms generally only need to apply the COBS suitability requirements to their dealings with retail clients. Firms are obliged to produce a suitability report to retail clients in relation to recommendations to buy or sell certain investment products, such as regulated investment funds. The reports must set out the client's demands and needs and explain why the investment is suitable and any risks attaching to the transaction.

- 4.61 COBS Chapter 10 provides that firms must seek to ensure that non-advised sales of MiFID financial instruments are appropriate for a client in light of his investment knowledge and experience (which the firm must ask about). The way in which these obligations apply vary according to the nature of the client (retail or professional) and the classification of the product for the purposes of the rules (as "complex" or "non-complex"). For example, in the case of "non-complex" products the requirements apply only where the proposed transaction results from a targeted 'personalised communication' to a client, at the initiative of the firm. If a firm concludes that a non-advised transaction is not appropriate for the client, it must warn the client. The appropriateness rules apply to MiFID business conducted with retail clients, to some additional non-MiFID derivatives, and to non-MiFID firms in relation to direct offer warrants and derivatives business.

*Markets in Financial Instruments Directive - MiFID*

- 4.62 MiFID came into effect in the EU on 1 November 2007 and applies to firms that provide investment services. MiFID applies to a wide range of financial products such as shares, bonds, derivatives and units in investment funds. It does not apply to deposits or loans, or to insurance products.<sup>23</sup>

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<sup>22</sup> The term "MiFID business" refers to investment services and activities and, where relevant, ancillary services carried on by an investment firm with its head office in the European Economic Area (or, if it has a registered office, that office) to which MiFID applies including, for some purposes only, a credit institution and UCITS investment firm.

<sup>23</sup> CESR - A Consumer's guide to MiFID Investing in financial products March 2008 (p.3)



- 4.63 MiFID ensures strong investor protection and has a comprehensive set of rules governing the relationship which investment firms have with their clients. For instance, Article 19 sets out the basic principles an investment firm should observe when providing investment services to clients (including the provision of personal recommendations), namely –
- (a) that it should act honestly, fairly and professionally in the best interest of its clients;
  - (b) that all information given to potential clients should be fair, clear and not misleading;
  - (c) that appropriate guidance should be provided on product risks, and
  - (d) that investment firms should obtain the necessary information regarding a potential client's financial knowledge, experience and objectives so as to enable the firm to make an informed recommendation that is suitable for the client.
- 4.64 As indicated above, under the MiFID 'appropriateness' requirements, an execution-only service can be provided to a customer if –
- (a) It relates to 'non-complex' instruments – including shares admitted to trading on a regulated market (or equivalent third country market), money market instruments, bonds and other securitised debt (but excluding bonds that embed a derivative), Undertakings for Collective Investment in Transferable Securities ("UCITS") (and others that satisfy a prescribed set of criteria);
  - (b) It consists only of execution of orders and/or the reception and transmission of orders;
  - (c) It is provided at the initiative of the client; and
  - (d) The client is warned by the firm that the firm has not assessed suitability.<sup>24</sup>
- 4.65 In May 2009, The Committee of European Securities Regulators ("CESR") published a consultation on how specific MiFID financial instruments (including various structured products) should be treated under the appropriateness requirements.<sup>25</sup>
- 4.66 In practice, distributors appear to claim that they are acting on an execution only basis which means they do not provide any advice to the investor in relation to the structured product. They spell out in the terms and conditions that they are not confirming that the investment is suitable for the investor. However, they do state that an investor should seek independent financial advice. That independent adviser will be bound by the COBS principles.

#### *Regulatory change*

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<sup>24</sup> FSA - Planning for MiFID Nov 2005 (p.11)

<sup>25</sup> CESR Consultation on MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements, 14 May 2009.



- 4.67 On 17 February 2009 Mr. Dan Waters of the FSA has also been reported<sup>26</sup> as saying that regulatory change would soon be forthcoming -

“He said the regulator was concerned about the range of structures and forms available in the UK market and highlighted that the CESR taskforce is in the process of considering how structured products should be distributed and sold to retail investors across Europe.

In its report, the taskforce recommends that there be a further elaboration of the application of criteria which determine whether products are non-complex and can be sold on a truly non-advised basis as well as analysis of certain key elements of the prospectus directive.

He said: “For certain types of wrapper<sup>27</sup>, we think that it is not altogether

clear that firms’ interpretations of how Mifid, the prospectus directive and the relevant applicable disclosure requirements interact, serve in a manner that is conducive to the optimal protection of the interests of retail investors.” Waters said some in the industry wanted structured deposits to have a comparable advised sales regime to other structured investments due to their “tendency to opacity, their frequent use of off-shore subsidiaries or sister companies, and diminished information disclosure requirements in comparison to investment products”.

*Thematic inspection relating to Lehman backed products*

- 4.68 The UK’s Financial Ombudsman Service has been dealing with a growing number of complaints relating to Lehman backed products and has agreed with the FSA that the issues raised should be considered under the Wider Implications process. In what is a significant use of FSA’s powers to protect a whole class of investors affected, the FSA announced on 8 May 2009 that it would conduct a thematic review of the way that providers constructed Lehman backed products and advisers sold them.
- 4.69 The FSA found significant advice failings on Lehman-backed products in most of the financial advice firms sampled, as well as serious deficiencies in the marketing literature provided by a number of the plan managers selling these products. As a result, the FSA has announced that it is taking direct action to address the detriment this has caused for investors with Lehman-backed products and robust steps to ensure all future structured products investors are treated fairly. The FSA published its findings in a Report on Quality of advice on structured financial products dated October 2009.
- 4.70 FSA will draw on the results of this review to determine whether there should be additional protections for – or even restrictions on – the sales of retail structured products, although any changes would need to be consistent with the EU-wide requirements (including MiFID).

<sup>26</sup> <http://www.moneymarketing.co.uk/cgi-bin/item.cgi?id=181064&d=pnd2&h=pndh2&f=pndf2>

<sup>27</sup> The term “wrapper” refers to the structure adopted for a product.



#### *Other regulatory action*

- 4.71 In March 2010 the FSA fined RSM Tenon Financial Services Limited £700,000 for significant failings in its advice and sales processes relating to Lehman-backed structured products. The FSA determined that RSM Tenon breached principles requiring that RSM Tenon ensure the suitability of its advice and discretionary decisions for any customer who is entitled to reply upon its judgment.

#### **Australian Regulatory regime**

##### *Market size*

- 4.72 According to estimates from JP Morgan, retail sales for structured products in the Australian market were worth around US\$2 billion for the half year to June 2007. This compares to US\$1.5 billion for the whole of 2006. "We expect that retail sales for structured products will be around US\$3 billion by the end of the year," JPMorgan vice president David Jones-Prichard said. "The great thing is when we look at the numbers for this year not only are they growing in volume, but the pace of that volume has increased."<sup>28</sup>

##### *Regulatory Regime*

- 4.73 The Australian Securities and Investments Commission ("ASIC") is responsible for administering the *Corporations Act 2001* ("Act"). ASIC is therefore responsible for securities, corporate regulation and advice or disclosure of insurance products sold, but not banking or the prudential regulation of general and life insurance. Chapter 7 of the Act provides for the regulation of financial services and markets, including the licensing, disclosure and conduct associated with the provision of financial services in Australia.<sup>29</sup>
- 4.74 ASIC is a regulator that only determines the level of disclosure required. There are no restrictions as to the types products can be offered to retail clients provided the marketing of the product conforms with Australian laws, such as suitability assessment obligations by advisors and the issuer and distributor also hold an Australian Financial Service Licence (or have an exemption) authorising them to issue and distribute the particular type of product offered.
- 4.75 In its Submissions to the Parliamentary Joint Committee Inquiry into Financial Products and Services in Australia August 2009<sup>30</sup> ASIC described the Australian Financial Services Regulatory Regime ("FSR") as follows –

"The FSR regime seeks to balance investor protection with market efficiency. As such, the regime regulates markets through conduct and disclosure regulation, that is:

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<sup>28</sup> <http://www.investordaily.com.au/cps/rde/xchg/id/style/3260.htm?rdeCOQ=SID-3F579BCE-4C4A1894>

<sup>29</sup> ASIC has issued many Regulatory Guides which can be found at this site - <http://www.asic.gov.au> (under publications – regulatory documents).

<sup>30</sup> [http://www.google.com.hk/search?hl=en&q=PJC+Inquiry+into+Financial+Products+and+Services&btnG=Search&meta=&aq=f&aql=q1&aql=&oq=&gs\\_rfai=](http://www.google.com.hk/search?hl=en&q=PJC+Inquiry+into+Financial+Products+and+Services&btnG=Search&meta=&aq=f&aql=q1&aql=&oq=&gs_rfai=)





- (a) conduct regulation – rules designed to ensure industry participants behave with honesty, fairness, integrity and competence, as well as rules relating to the settlement of disputes between market participants and investors; and
- (b) disclosure regulation – rules designed to:
  - (i) overcome the information asymmetry between industry participants and investors by requiring disclosure of information required to facilitate informed decisions by investors; and
  - (ii) promote transparency in financial markets<sup>31</sup>

*Product Disclosure Statement ("PDS") or Prospectus Regime*

- 4.76 Disclosure requirements for offers of securities are specified in Chapter 6D of the Corporations Act. The requirements include the need for a disclosure document (such as a prospectus) to accompany offers of securities unless an exemption applies. Prospectuses must include all information that investors and their professional advisers would reasonably require to make an informed assessment of the issuer and the securities being offered and make specific disclosures.<sup>32</sup>
- 4.77 If the product is a financial product (other than securities) and it is intended to be offered to retail clients then a regulated person must provide a PDS, that meets the requirements in s1013B to M of the Act, to the client before he acquires the financial product. The PDS is the point-of-sale document that sets out the significant features of a financial product, including its risks, benefits and cost.
- 4.78 The broad objectives of a PDS are to help consumers compare and make informed choices about financial products. To achieve these objectives, the legislation requires that all information contained in a PDS must be worded and presented in a clear, concise and effective manner. ASIC has also published some Good Disclosure Principles in RG168.
- 4.79 ASIC does not pre-vet any PDS prior to its release to consumers unless there are exceptional circumstances.<sup>33</sup>
- 4.80 The flow of events requiring the issuer to put together a PDS needs to be explored a little closer. The main points are as follows –
  - (a) A PDS is only required for products that are offered to retail clients and not wholesale clients (for the definition of these please refer to s761G of the Act);
  - (b) A PDS is only required if the product being offered to the retail client is a financial product (for the definition of financial product see Pt 7.1 -

<sup>31</sup> See paragraph 8 of the Submissions by ASIC to the PJC Inquiry into Financial Products and Services in Australia August 2009.

<sup>32</sup> See paragraph 487 of the Submissions by ASIC to the PJC Inquiry into Financial Products and Services in Australia August 2009.

<sup>33</sup> ASIC Regulatory Guide 168 Disclosure : Product Disclosure Statements



Division 3 of the Act); and

- (c) if the provision of securities is by way of a prospectus, rather than a PDS, it is covered by Chapter 6D and not 7 of the Act.

*Licensing regime*

- 4.81 If you provide advice on financial products to retail clients then s.911A of the Act requires that you hold an Australian Financial Service Licence (or have an exemption) authorising them to issue and distribute the particular type of product offered<sup>34</sup>, and trained to a particular level under ASIC's Regulatory Guide 146. The Australian Stock Exchange (the markets regulator) also requires particular levels of training for particular products which are traded on the exchange.

*Suitability determination*

- 4.82 Australia imposes a product suitability obligation on financial advisers who are recommending a product to retail investors under the Act (effective March 2004). S945A of the Act essentially requires a financial planner, who provides investment advice, to –
  - (a) Know the client;
  - (b) Know the product;
  - (c) Match the 2 pieces of information together.
- 4.83 The Act further specifies that the basis of investment recommendation must be set out in the Statement of Advice ("SOA") given to client. The SOA must also set out the benefits of switching investment if such recommendation is given.
- 4.84 ASIC has issued various Regulatory Guides to explain the interpretation of the statutory requirement. For example, RG175 explains the requirements of "reasonable basis" of advice and the minimum level of documentation required. RG146 covers training given to the staff of financial planner. RG181 deals with conflicts of interest issues.
- 4.85 Investment advice given to retail investors can be broadly subdivided into two types. General investment advice (e.g. a TV advertisement mentions that retired person should consider capital protected investment) does not attract full disclosure/suitability obligation. However, ample warning must be given that this is just a general advice which has not taken into account of the particulars of any investor. Specific investment advice given must be documented in a statement of advice. Relevant product disclosure document will be provided to the client if specific product is recommended at the same time.
- 4.86 Section 945A(1) of the Act requires that financial advice to retail clients including financial product recommendations have regard to "information

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<sup>34</sup> RG 36 contains the requirements of an Australian Financial Services License.



obtained from the client in relation to [his/her] personal circumstances ..." and that "the advice is appropriate to the client, having regard to that consideration and investigation". The products should be recommended based on the investor's risk appetite which means a conservative investor can still invest a small portion of his portfolio in relatively high risk products. For example, it is more important to ensure an 80 years old investor not be advised to invest in a long term plan. Moreover, the law does not require the financial planner to disclose to the investor of his risk profile.

- 4.87 Additionally, s947B(2)(b) of the Act requires that the Statement of Advice contain the information about the basis on which the advice is or was given. This includes any risk profiling performed on an investor as it would go to the basis on which the advice was given.
- 4.88 The Act sets out strict liability on the financial planners in some circumstances. However, the requirement under s945A(1) of the Act to have a reasonable basis for the advice is not a strict liability offence although breach is a criminal offence. Some contraventions of the Act are designated to be criminal offences.
- 4.89 However, the submissions by ASIC to the Parliamentary Joint Committee Inquiry state (at para 362) that :

"Currently in the Australian FSR regime, only personal advisers are subject to a duty to ensure that products recommended to retail investors are suitable. Retail investors can acquire any product (including complex and risky products such as derivatives and structured debt products) on an execution-only basis or with general advice only. In these circumstances the intermediary has no obligation to ensure the product is suitable for the retail investor"

#### *Cooling off period*

- 4.90 A 21 days cooling off period applies to some investment products for example insurance products, registered managed investment schemes and superannuation funds, but not securities traded on the exchange (as listed securities have market liquidity). Clients have absolute right to withdraw from the investment within 14 days from the date of purchase but the investor must bear certain costs and the market fluctuation losses.

#### *Dispute resolution*

- 4.91 All distributors are required to be a member of financial dispute resolution body as specified in the licensing requirement. Clients will be informed of such dispute resolution mechanism in the Financial Services Guide given to client at the point of providing recommendation. Various dispute resolution bodies (dealing with different investment products) have recently been merged into one national body – the Financial Ombudsman Service. The maximum claim amount to use the service without charge HK\$280K. ASIC provides a guide to the required disclosure of dispute resolution facilities in RG 165.
- 4.92 All financial planners are required to take out professional indemnity insurance. However, there are only 5 insurance companies providing such PI insurance



coverage so that the premium is getting much higher. For example, one firm with over 10,000 clients will pay annual premium of A\$650K<sup>35</sup>.

## Singapore

### *Market size*

- 4.93 We do not have figures for the total volume of structured products sold to retail investors in Singapore. Nevertheless the Monetary Authority of Singapore ("MAS") has provided figures for those structured products facing difficulties –
- (a) Lehman Minibond Programme: S\$375 million were sold to about 8,000 retail investors through nine distributors. Over 80% invested up to S\$50,000, with 28% having bought S\$10,000 or less.
  - (b) Merrill Lynch Jubilee Series 3 LinkEarner Notes: S\$23 million were sold to about 350 investors through six stockbroking firms. Again, over 80% invested up to S\$50,000, with 28% having bought S\$10,000 or less.
  - (c) DBS High Notes 5: S\$103 million worth of notes were sold to 1,400 investors. More than half of them invested S\$50,000 or less.<sup>36</sup>
  - (d) Morgan Stanley Pinnacle Notes Series 9 and 10: S\$26 million were sold to about 700 retail investors through five distributors.<sup>37</sup>

### *Regulatory Regime*

- 4.94 The Monetary Authority of Singapore is responsible for banking, insurance and securities regulation. The MAS now administers the various statutes pertaining to money, banking, insurance, securities and the financial sector in general. Its functions include the conduct of integrated supervision of financial services and financial stability surveillance.<sup>38</sup>

### *Prospectus Regime*

- 4.95 The offer and distribution of investment products in Singapore are governed by the Securities and Futures Act ("SFA") and the Financial Advisers Act ("FAA") respectively. The regulatory approach of the MAS comprises two key elements: first, adequate disclosure by the issuer to investors of the features and risks of an investment product; and second, where advice is given, a reasonable basis for the adviser's recommendation.<sup>39</sup>
- 4.96 Under the SFA, any offer of securities must be accompanied by a disclosure document, most often a prospectus. Any offer of structured notes to retail

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<sup>35</sup> The insurers do not calculate their premia purely based on the number of planners, but rather they look at multiple factors including income.

<sup>36</sup> Reply to Parliamentary Questions on the Sale of Structured Products to Retail Investors 20 Oct 2008

<sup>37</sup> [http://www.mas.gov.sg/consumer/other\\_structured\\_products/pinnacle\\_faqs.html](http://www.mas.gov.sg/consumer/other_structured_products/pinnacle_faqs.html)

<sup>38</sup> [http://www.mas.gov.sg/about\\_us/Introduction\\_to\\_MAS.html](http://www.mas.gov.sg/about_us/Introduction_to_MAS.html)

<sup>39</sup> The following information is mainly taken from the MAS Consultation Paper - Review of the Regulatory Regime Governing the Sale and Marketing of Unlisted Investment Products March 2009



investors would need to be made in or accompanied by a prospectus (which could consist of a base prospectus and pricing statement). The issuer must include in the prospectus all the information that an investor would reasonably need to make a proper assessment of the securities being offered. The issuer and its advisers are responsible for ensuring the prospectus complies with the law.

- 4.97 MAS checks, based on information provided by the issuer and its advisers, that the prospectus discloses the risk and product features, and that there are no false or misleading statements. If MAS is satisfied, MAS will register the prospectus. MAS does not judge the merits of the investment. This is expressly stated on the cover of the prospectus so that investors understand that the securities are not endorsed by MAS.

*Advice by Financial advisers*

- 4.98 The FAA regulates the sale and advisory process for financial products, and sets out the steps to be followed when giving advice on investment products. Financial institutions and their representatives must have a reasonable basis when recommending investments, having considered the investment objectives, financial situation and needs of the investor.
- 4.99 Financial institutions bear the primary responsibility for ensuring that they and their representatives comply with these requirements. MAS supervises the industry using a range of supervisory tools. These include conducting offsite reviews and thematic inspections.
- 4.100 MAS also set out in its proposed *Guidelines on Fair Dealing – Board and Senior Management Responsibility Responsibilities for Delivering Fair Dealing Outcomes to Consumers (“Fair Dealing Guidelines”)* on 3 April 2009 its expectations that the board and senior management of financial institutions bear primary responsibility for embedding a culture of dealing with their customers fairly. The *Fair Dealing Guidelines* explicitly articulate the five fair dealing outcomes which financial institutions are expected to achieve, and provide guidance on issues that the board and senior management of financial institutions should address for each outcome.

- 4.101 The five outcomes are –
- (a) Customers have confidence that they deal with financial institutions where fair dealing is central to the corporate culture;
  - (b) Financial institutions offer products and services that are suitable for their target customer segments they target;
  - (c) Financial institutions appoint have competent representatives who provide customers with quality advice and appropriate recommendations that meet their financial objectives and suit their personal circumstances;
  - (d) Customers receive clear, relevant and timely information to make informed financial decisions; and



- (e) Financial institutions handle customer complaints promptly and in a consistent in an independent, effective and prompt manner.

*Proposals for change*

4.105 MAS issued a Consultation Paper in March 2009 which contains proposals to further safeguard consumers' interests and promote higher industry standards for the sale and marketing of unlisted investment products. The proposals were formulated based on MAS' review of the sale and marketing of unlisted investment products after the current global financial crisis led to the failure of several structured notes in Singapore.

4.106 In September 2009 and January 2010 MAS issued responses to feedback on the proposals. It decided:

- (a) To require issuers to prepare a short, user-friendly Product Highlights Sheet which would be separate from the prospectus for a product.
- (b) To require issuers to make available, publicly and regularly, bid or redemption prices of unlisted investment products but this would merely be an indicative price and it would not be an exit mechanism for investors.
- (c) To require financial institutions to undertake an enhanced product due diligence process before selling new investment products so that they only offer products that are suitable for their target customer segments.
- (d) To require representatives to enhance the quality of information obtained from their customers and to document the advice given.
- (e) Against introducing a definition of "complex investment products", and dropped its proposals for risk rating of retail investment products, mandatory advice for the sale of complex investment products, and "health warnings" for complex investment products;
- (f) Against introducing a civil penalty regime for persons regulated by MAS for breaches of the FAA;
- (g) To monitor how remuneration structures for the sale of investment products were disclosed to clients;
- (h) To require an approved trustee to be appointed for unlisted debentures with a covenant binding the trustee to exercise all due diligence and vigilance in carrying out its functions;
- (i) To provide statutory protection to trustees from liabilities incurred in taking bona fide actions in compliance with MAS' directions; and
- (j) To strengthen MAS' powers to investigate and take regulatory actions.

In place of the complex investment products regime, MAS has developed a revised package of proposals that will apply to both listed and unlisted investment products. MAS is conducting a separate consultation on the revised proposals.



6. In connection with paragraph 138 of S57 on the use of the term "quick wins", please advise:
- (a) whether SFC had used the term "quick wins" in any of its documents relating to the pursuit of its regulatory objectives. If yes, please provide the details; and
  - (b) the "quick-wins" that SFC has come up with and delivered since June 2002.
- 6.1 On 28 June 2002, the Financial Market Development Task Force ("FMDTF") submitted its first phase recommendations to the then Financial Secretary. According to the press release issued by the Administration on the same date, these recommendations "include some quick-win proposals to facilitate the issuance of retail debt and equity and to increase liquidity in the securities and futures markets. **Such proposals are expected to be implemented later this year** (emphasis added)." On contrary of "quick-win" proposals, we understand long-term measures are those that require legislative changes and/or further examinations.
- 6.2 SFC thereafter implemented a number of interim measures in consultation with the Administration. For instances, the SFC published three sets of guidelines to facilitate offers of shares and debentures in February and March 2003 –
- (a) Guidelines on the content and manner of publication of certain publicity and disclosure materials that may be issued to the public in Hong Kong;
  - (b) Guidelines facilitating offers of shares or debentures on a repeat or programme basis using separately registered programme and issue prospectuses; and
  - (c) Guidelines providing for relaxations so that faxed copies of experts' consent letters and a bulk print proof of the prospectus may be accepted for registration under the CO in certain circumstances.